

## CURRENCIES AND CREDIT MARKETS

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**"In order to form an opinion on the policy of deflation and liquidation it must be first recognized that every depression is a depression of profits occasioned by the fact that the price curve and the cost curve cut."**

*Crises and Cycles, Wilhelm Röpke, 1936, p.180*

### HIGHLIGHTS

The world economic situation is definitely worse than expected and probably worse than most people realize. Economic weakness is most pronounced in the "bubble" economies — the United States, Japan, Britain, Canada, Australia and also some Scandinavian countries.

There are many downward forces on the U.S. dollar — both internal and external, both short- and long-term. A disappointingly weak U.S. recovery and Germany's unyielding interest rate policy are the main depressants.

It has taken most economists a few years to realize that this recession is different from any other in the last 50 years. As in the 1930s, there is a general uncertainty about just what is restraining the economy. We review the forces impeding recovery.

The comforting conclusion of most economists — the Fed included — is that falling inflation and interest rates signal improving economic health and an imminent recovery. We explain why that's an ill-founded view.

A non-inflationary environment is no cure for the condition we see in all the "bubble" economies: overindebtedness associated with a savage profit and income squeeze. It's instructive to recall that the United States, to no avail, witnessed its greatest period of price stability in the 1920s.

We conclude that the U.S. economy can provide no support for the dollar. Given the devastating money and credit picture, the available data virtually scream of triple-dip recession.

German short-term interest rates will not be coming down for many months. A substantial decline may be years off yet. Certainly, an easing looks improbable before spring or summer of next year.

Given all the negative factors for the U.S. dollar, bulls are clinging to their last hope: the purchasing price parity (PPP) theory. We present devastating evidence why PPP is nothing more than a myth.

Pressures on the European Rate Mechanism are building. Although the bursting point may still be some way off, we issue a warning.

We see nothing that might cause the dollar to bottom out any time soon. Although a bond play may be delayed, the D-mark and the Swiss Franc remain the most attractive currencies. Above all, safety and income should take priority.

## **DANCING AMONGST THE WOLVES**

Wall Street is again whipping itself from euphoria into ecstasy. Why? There doesn't seem to be any other reason than this: at long last the market has convincing evidence that the U.S. economy is slipping from sluggish growth back to stagnation . . . if not worse. Oddly, it was the startling drop in consumer confidence — many times larger than expected — that was announced by the Conference Board recently that sparked the outburst of joy. In reassuring bond markets that neither recovery nor inflation were imminent, bond yields fell, thus setting off investors in hot pursuit of stocks.

In the meantime, increasing gloom over world economic prospects has begun to infect financial markets. Almost everywhere, stock prices are down sharply from their May peaks. Only Wall Street, obsessed with the levitating effects of lower interest rates and consoled by falling inflation, seems to rejoice at the prospect of an economic slump.

Given the recent bout of dollar weakness, global stock market tremors, and a flare-up in the price of gold, one has to wonder if things aren't beginning to unravel. We are not quite at that stage yet. Although the dollar's weakness has shocked the consensus, U.S. stocks and bonds in that regard have been relatively unruffled. In a true "dollar crisis," U.S. stocks and bonds would most probably slump in sympathy. Both the U.S. dollar and the U.S. stock market are still underpinned by widespread faith in a U.S. recovery, though it is believed to be temporarily delayed. But the risks are increasing that this faith that has persisted throughout the vicissitudes of the past 18 months will finally crack.

## **A GLOBAL ECONOMIC CHASM**

Altogether, the world economic situation is definitely worse than expected and probably worse than most people realize. Economic weakness is most pronounced in the "bubble" economies — the United States, Japan, Britain, Canada, Australia and also some Scandinavian countries. In Continental Europe, economic activity remains lacklustre, increasingly at the cost of worsening unemployment rates outside of Germany. The more optimistic economic forecasts — which we never shared — are being spoiled by the Bundesbank's tight-fisted policies and dollar weakness.

Surveying the world's industrial economies as a whole, we see a polarization taking place into two groups; each has a fundamentally different set of problems from the other. By far the biggest group — which includes the major economies of Japan and the United States — are the bubble economies as already mentioned. Their prolonged weakness has its root in asset deflation and associated debt deflation, both being the legacy of the previous credit and asset inflation.

On the other side is Continental Europe which is caught in the financial aftermath of German unification, an event that has profoundly changed the economic relationship between Germany and the rest of Europe. The targets set out by Maastricht (the 1991 conference that set out the agenda for European economic and monetary unification) and a European obsession with fixed exchange rates against the D-mark — what some call a macho-virility syndrome — have locked pan-European monetary and fiscal policies into the restraining mode presently suited to Germany. With Maastricht already on the ropes due to Denmark's opting out, no country wants to be the first to blink.

## **THE MISUNDERSTOOD IMPEDIMENTS TO RECOVERY**

Essentially, economic forecasts have generally been revised downward again. But are these forecasts any more realistic than before? How weak is weak? Is the new dip in the U.S. economy going to deepen? No, say Mr. Greenspan and most economists, the same people, incidentally, that never saw an approaching

recession in the first place. Their informed guess is that a progressive monetary easing and steadily falling inflation have finally laid the foundation for a sustained expansion in the U.S.. The same sentiments are found in the other bubble economies.

All of these economies, in reality, are suffering from numerous maladjustments, distortions and imbalances that find no expression in the consumer price indices. It's a complicated matter to examine. Nevertheless, we'll briefly mention a number of the common characteristics. The first one, which strangely attracts little discussion, is that business profits are battered, not just cyclically, but also from a long-term secular vantage point. Profits in Britain, Canada, the United States and Australia have all witnessed long slumps relative to GNP. Other common characteristics are savage asset deflation (collapsing real estate markets) and busted banks. Last, but not least, these economies are all confronted with the same virtual collapse in money and credit growth.

There are differences, too. The most important one concerns the nature of the structural distortions that result from the preceding credit inflation. In the Anglo countries, the borrowing excesses went massively into boosting consumption at the expense of productive investment and were occasioned by gapping trade deficits. In Japan, the credit excesses vented themselves very differently: industrial investment boomed instead, and the trade surplus soared. The Anglos used the credit excesses to consume while the Japanese used them to invest.

Given this environment of a vicious money and profit squeeze, the astounding thing is the isolated bullishness of the U.S. stock market. The most obvious reason to us is the Fed's aggressive easing. America's yield curve, the spread between short and long-term interest rates, is unique in history and unique in the world. The lowest short-term interest rates in more than three decades have launched a virtual flight of savers, suffering large income losses, from low-yielding financial instruments into stock and mutual funds in a quest for higher return and income. Brokers and their economists then deliver the quantitative valuation models that rationalize the ridiculous stock price levels and trigger the asset shifts; the buyers create believers, and the believers create buyers.

Given the spectre of monetary and economic data going from bad to worse, this bullishness in financial markets becomes harder and harder to understand. Pure and simple, recent economic and monetary statistics are fodder for a continuing recession. At best, the U.S. economy now appears locked into an exceedingly sluggish "growth recession." But even this pace could readily dissipate.

### **THE DOWNWARD FORCES ON THE DOLLAR — SHORT- AND LONG-TERM**

Since our last letter, a discount rate hike by the Bundesbank and a clear weakening trend in the U.S. economy sent the dollar tumbling to within a hair of a new low against the D-mark (to DM 144.60 versus the 1991 low of DM 144.30.) The dollar's dive has made shambles out of the incessantly bullish forecasts that saw the currency soaring to as high as DM 1.85 and even DM 2.00. Thanks to central bank intervention, the dollar has temporarily stabilized.

As we have always stressed, the dollar's two rallies — both early last year and this year — were essentially nothing more than speculative bubbles. In both cases, the rallies were underpinned by speculation that the U.S. would experience a sustained recovery with rising interest rates while rates would decline in Germany.

Actually, the appalling failure of the consensus to understand the deep-seated causes of the U.S. economy's prolonged weakness was matched by an equally appalling failure to realize that Germany's economic

difficulties arising from unification were bullish, not bearish, for the D-mark. The "bear" case for the D-mark lacked any logic and was nothing more than wishful thinking that the Bundesbank would capitulate to economic weakness and foreign pressure and lower its interest rates prematurely.

To be sure, the downward forces on the dollar are manifold — both internal and external, both short- and long-term. Two forces are dominating presently: disappointment over the weak U.S. recovery and disappointment in Germany's unyielding interest rate policy. As a result, the U.S./German short-term interest rate differential, instead of converging, has opened up to an unprecedented chasm of 650 basis points (6.5 percentage points.)

The consensus, though, views these forces as only temporary and believes that they will soon pass. For them, the arrival of a sustained U.S. recovery and a German easing is only a question of time. It's precisely these views that the markets have been discounting.

Not reflected in the markets is the greatest threat of all to the dollar: a combination of three inter-related, deep-seated changes that are at work over the long-run — (1) prolonged sub-par economic growth; (2) interest rates that will need to remain at low, internationally unattractive levels; and (3), permanently high trade deficits reflecting lagging growth of manufacturing and export capacity.

What we really are talking about are the adverse supply-side consequences of many years of undersaving and underinvestment, particularly in the manufacturing sector. This applies similarly to all the Anglo economies — the United States, Britain, Canada, and Australia.

### **THE BUNDESBANK STAYS COMMITTED**

The main depressant for the U.S. dollar, both over the short- and long-term, are the problems of the U.S. economy. Presently, that's aggravated by the Bundesbank's unusually high interest rates. Just what is to be expected in Germany?

Early this year, the dollar soared on the assumption that the Bundesbank would begin to ease no later than this autumn. Today, such an easing looks improbable before spring or summer of next year . . . yes, as much as 6 to 12 months away. In this respect, the Bundesbank's latest Monthly Reports made painful reading. So far in 1992, monetary growth has run at an annualized rate of about 9%. That compares uncomfortably with a target range of 3.5% to 5%. While the Bundesbank admits that money growth is distorted by an inverted yield curve (short-term rates being higher than long-term rates) it emphasized the following: "*[that] the main factor behind the excessive money growth is a marked credit expansion. Bank lending to the private sector again rose sharply at an annual rate of 11.5% between January and April.*" Credit inflation is the key. If allowed to continue, it's bound to lead to price inflation, asset inflation, wage inflation, a rising trade deficit, or any combination thereof. Another Bundesbank tightening cannot be ruled out.

The Bundesbank's reference to credit, by the way, highlights a key difference between U.S. and German monetary policy. In assessing the significance of the fast-growing monetary aggregates, the Bundesbank carefully analyzes the credit counterparts to this broad money expansion. On this score, credit growth is much too high for comfort.

Credit to the private sector, which is mostly financed by the banking system, is being buoyed by a plethora of tax subsidies for investments in east Germany. To this is added the vast borrowing requirements of the

public sector. East German consumption and investment is currently about twice the level of east German output. This gap, equal to 6.5% of west German GNP, is being covered by a transfer of resources from west Germany. Two-thirds of these resources have come out of the trade balance by wiping out the formerly large export surplus. On the domestic side, the main conduit for the balance of resources is the government budget deficit which has since soared.

### **GROWING RISKS IN THE ERM**

The important point to see is that these unification-related shifts have led to a profound change in the economic relationship between Germany and the rest of Europe. In contributing to Germany's permanently higher domestic credit demand and high real and nominal interest rates, this shift has clearly destroyed Europe's former equilibrium. Europe's exchange rate stability during the 1980s had been increasingly founded on a strong, low-yielding D-mark. It was associated with large German capital outflows which financed (even overfinanced) the soaring deficits of countries with high-yielding currencies. Between mid-1985 and late 1988, the Bundesbank's Lombard rate stayed put between 4.5% and 5.5%. Presently, it is stuck at 9 3/4%, a virtual doubling.

Yet, this discussion about the adverse interest-rate effects of unification on Europe is pretty one-sided. It's rarely mentioned that unification also provided Europe with massive demand effects. Exploding east German demand spilled over to the rest of Europe by way of soaring German imports and sharply narrowing inter-European trade gaps. Between 1988 and 1992, German imports of goods and services jumped from 23.8% of German Gross Domestic Product (GDP) to 28.3%. These demand "spill-over" effects continue to underpin the European economy as a whole, only now they are no longer expanding. What's left, on the other hand, is the more permanent pressure of Germany's high interest rates.

In hindsight, it is easy to see that a substantial pre-emptive DM-revaluation within the European Rate Mechanism (ERM, the arrangement that governs the trading range of European currencies relative to each other) would have been the most sensible response right in early 1990. It would have capped German inflation and interest rates at lower levels without transmitting so much pain to the rest of Europe. Considering Germany's superior price stability during the 1980s, it also would have made perfect sense from the perspective of correcting an undervalued mark. During the 1980s, Germany's consumer price inflation had only averaged 2.6% per annum, compared with 6.6% in the European Community (EC) as a whole and 4.6% in the United States.

Bygones are bygones. The chance to moderate the inflation pressures originating from unification through a DM-revaluation within the ERM has been missed. It was never considered. Keeping up with the D-mark has become an obsession among European politicians. Inflation fighting in Germany was left to the Bundesbank; it acted with vengeance. Essentially, the higher inflation rates required correspondingly higher German interest rates to which the other countries had to adjust despite their weakening economies. It's a terrible dilemma.

Yet, Germany's partners can hardly complain. It was their voluntary choice, after all, to link their currencies to the D-mark for better or worse. In fact, many countries expressly linked the weak currency to the strong D-mark as an easy device to lower their long-term interest rates by luring in foreign capital. Until recently, the linkage usually did the trick as international investors regularly stampeded into the higher-yielding bonds, calling them "high-yielding Deutschmarks." We have always expressed our misgivings over this game.

The first to spoil this so-called convergence game were the Danes with their recent "no" vote on Maastricht. There are other spoilers: the weak dollar, the stubborn Bundesbank and growing doubts generally about a successful ratification of the Maastricht accords thus raising the spectre of coming currency turmoil. Ironically, the perception of a weakening DM-link has boosted non-German bond yields, particularly Spanish peseta, Italian lira and ECU. Even French government bond yields have risen approximately 50 basis points to a level of 9.5% in the last month. It would be hard to blame that on the Bundesbank. Apparently, the credibility of the Banque de France, left to its own, is still not the best.

### **NO PROSPECTS FOR GERMAN EASING**

For Germany, the present inflation rate of 4% and higher is intolerable. It has always been the Bundesbank's policy to suppress inflation as fast as possible before a price-wage spiral became firmly embedded. Though it might be used as an excuse that tax hikes have distorted the inflation price indices on the upside, the trade unions are not so kind to discount this in their wage demands.

Although the indications of strain on the ERM remain below crisis levels, the D-mark has gained sharply against all the higher yielding currencies in the ERM (notably the peseta, lira and British pound). Pressures for realignment are building up as economic weakness and soaring unemployment outside of Europe worsens, thus heightening the strain between domestic and external policy requirements. D-marks and Swiss Francs have become the "safe havens" for the risk-adverse investors. Dollar weakness could considerably aggravate the monetary tensions in Europe, further favouring the D-mark against other European currencies.

In conclusion, there is a strong body within the Bundesbank's council that wants more tightening. At best, German short-term interest rates will not be coming down for many months and a substantial decline may yet be years off. That may sound like a recommendation to sell German bonds and to rush into the bonds of countries with low inflation and prospects of earlier monetary easing. It is not.

The point to remember is that interest rates in many other countries, especially so in the Anglo countries, have already fallen to multi-decade lows and are therefore nearer lows than highs. It is rarely a good idea to buy bonds after interest rates have already fallen substantially. Accordingly, there is little upside potential in other bond markets. Currency and deficit problems loom large. Safety and income should take priority. Therefore, the D-mark and the Swiss Franc remain attractive currencies.

### **NO HELP FROM THE U.S. ECONOMY**

If there is no scope for German interest rates to fall over the next 6-9 months, then any support for the U.S. dollar must come from rising U.S. interest rates. We don't see that either. To us, all the data still points to a weakening U.S. economy.

Apparently, that's not the view of the experts at the U.S. Fed. Their masterly logic gave authorship to these two contradictory comments found in the Monetary Policy Report to Congress of July, 1992:

*"The strength in final demand that seemed to be emerging in the early part of the year does not appear to have carried through to the second quarter."*

*"In quantifying their views of the prospects for economic growth, the Board Members and Reserve Bank presidents ended up with forecasts that are somewhat stronger than in February."*

**GROWTH OF MONEY AND DEBT**  
(percentage change)

	<u>M1</u>	<u>M2</u>	<u>M3</u>	<u>Debt</u>
1986	15.5	9.2	9.0	14.1
1987	6.3	4.3	5.9	10.4
1988	4.3	5.2	6.4	9.4
1989	0.6	4.8	3.6	8.1
1990	4.2	4.0	1.7	7.0
1991	8.0	2.8	1.2	4.4
1992 Q1	16.5	4.3	2.2	3.8
1992 Q2	9.9	0.0	-1.9	5.1

Source: Federal System, Monetary Policy Report to Congress, July 20, 1992, p.26

**GROWTH OF MONEY AND DEBT**  
(percentage change)

	<u>M1</u>	<u>M2</u>	<u>M3</u>	<u>Debt</u>
1992 Q1	18.0	3.9	1.6	3.1
1992 Q2	5.6	-1.7	-3.1	5.2

Source: Federal Reserve Statistical Release, H.6

In his speech to the Banking Committee, Mr. Alan Greenspan was highly convincing in one respect: he and his colleagues were at a complete loss to understand the persistent, extreme weakness of the broader money aggregates. Ominously, the picture is worsening rapidly as the adjacent table shows. But, checking these figures, we noticed with bewilderment that they diverge considerably from the Fed's regular money supply release for the first half of 1992, which looks rather more frightening and is found in the second table.

Mr. Greenspan really ought to have said: "I, Alan Greenspan, chairman of the Fed, must confess to you with deep regret that we have lost control of the money and credit supply. Beginning more than three years ago, we have undertaken an unprecedented number of interest rate cuts. Short rates are at 30-year lows. Not only that, we have flooded the banking system with excess reserves. In addition, the budget deficit has exploded. Yet, this massive input of stimulative measures achieved no more than a brief, anaemic response in the economy, which even now is petering out."

Instead, Mr. Greenspan embarked on a new comforting explanation of the "aberrant monetary behaviour that has emerged in 1990 and has since intensified." To summarize his findings, he said: "The weakness of the broad monetary

*aggregates appears importantly to have reflected the variety of pressures that rechannelled credit flows away from depository institutions, lessening their need to issue monetary liabilities. The public, in the process of restructuring and deleveraging balance sheets, found that monetary assets had become less attractive relative to certain non-monetary financial assets or to debt repayment."*

### EXPLAINING THE WEAK MONETARY TRENDS

Apparently, the Fed does not want to see the obvious: namely, that the weak money supply shows exactly what it is supposed to show — a weak economy. Their explanation really boils down to a brand new theory according to which aggressive monetary easing and interest-rate cuts cause a shrinking money supply. By this logic, they ought to raise interest rates in order to boost the money supply by channelling money back to the banks.

It's rather terrifying to think that the monetary leaders of the world don't understand how money is created and destroyed. Another comforting touchstone they use as an excuse is changing money velocity. The argument here is that the same rechanneling process which depresses broad money growth also tends to boost the velocity of the broader money aggregates therefore offsetting the sluggishness of broad money growth. Mr. Greenspan literally spent about half of his testimony on monetary technicalities. After having created utter confusion, he was able to finish with this promising conclusion: "I expect that the economic expansion will soon gain momentum which lower inflation should help to maintain."

We answer him with a quotation from Keynes: "Money velocity is, in itself, merely a name which explains nothing . . . The use of this term obscures the real character of the causation, and leads to nothing but

*confusion.*" Yes, money is mainly being shifted from low-yielding bank and thrift deposits into stock and bond mutual funds in search of higher returns. In the Fed's superficial view, this has no relevance for the real economy because it supposedly reflects "rechannelled credit flows."

First of all, such a rechannelling of credit flows can hardly be regarded as a substitute for a credit expansion. Even worse is the Fed's failure to recognize that the switch from bank deposits to mutual fund shares implies a completely different use of money. While bank deposits mainly finance business and consumer spending, mutual fund shares finance the purchase of stocks and bonds. What happens is that the part of the money supply that serves financial speculation increases at the expense of the part of the money supply that serves economic activity. While the real economy starves of liquidity, the financial markets wallow in liquidity.

Focusing on monetary technicalities of such secondary importance, Mr. Greenspan at least managed to divert attention from the root of the matter: With all its reserve injections and interest rate cuts, the Fed has been unable to restart the credit machine. The normal process by which borrowing and lending finances spending and creates incomes, remains literally jammed. The Fed still fails to recognize credit growth as the indispensable requisite of recovery. During the first quarter of 1991, private (non-federal) borrowing grew at a 3% annual rate. Taking into account inflation and debt service costs, that rate of growth really represents a contraction.

Mr. Greenspan and the Fed's policy report dwells at length on the healthy effect of lower interest rates by "*reducing debt-service obligations and facilitating needed balance sheet restructuring by borrowers and lenders.*" By lenders they clearly mean solely banks and thrifts, not their depositors which are the true, ultimate lenders and actually the losers in this case. Relief for the borrower is, dollar for dollar, the loss of the saver. As a result, there is no income gain in the aggregate. One wonders who the Feds are fooling other than themselves.

### **THE DECOUPLING OF MONEY**

In one respect, Mr. Greenspan was perfectly right, though for the wrong reason. It concerns his remark that money growth fell faster than nominal GNP growth, from which he drew his comforting conclusion about rising money velocity.

The peculiar downturn in U.S. money and credit growth really started in 1988 — see table on the previous page — and accelerated sharply in early 1990. By these measures, it's quite astonishing really that the U.S. economy hasn't been any weaker. The reason for that isn't difficult to see — soaring U.S. exports. The money growth that fuelled U.S. economic growth during these years took place in the rest of the world resulting in soaring demand for U.S. exports.

In the 1988-91 period, real U.S. GNP expanded by altogether \$308 billion, with exports accounting for \$173 billion of this gain or almost 60%. Imports rose \$51 billion. Clearly, it was this unique export boom during this period that also broke the normal link between money growth and GNP growth. In other words, soaring exports boosted U.S. GNP growth independently of U.S. domestic money and credit growth.

Assessing the economic situation in the United States, it's of uttermost importance to recognize the propulsion role of exports since 1987. Otherwise, the U.S. economy would long since be in a much deeper recession. But now the powerful export machine is decoupled. That's the important new point. Falling exports have begun to trim U.S. GNP growth.

In the second quarter of this year, GNP grew 1.4%. As this is an annualized rate, it represents nothing more than a crawl. While consumption stagnated, sagging net exports slashed 1.2 percentage points from the GNP growth rate. As a result, real final sales rose only 0.3%. The one and only positive was business fixed investment. What was also noteworthy in this report was that previous growth estimates for 1990 and 1991 were cut from 1.0% to 0.8% and -0.7% to -1.2%, respectively.

Obviously, what's urgently needed now is a stronger domestic demand pull to offset export weakness. But looking around, we don't see any single domestic demand component that is gathering momentum or might do so. In combination with the devastating money and credit picture, the available data virtually scream of triple-dip recession.

### **WHAT'S WRONG WITH THE ECONOMY?**

It has taken the Fed and most economists a few years to realize that this recession is different from any other in the last 50 years. But, just as in the 1930s, there is a general uncertainty about exactly what is impeding a normal economic recovery.

Most commentators, including the Fed, are focusing on the debt excesses of the 1980s and the legacy of debt problems. Overindebted businesses and households are essentially retrenching for a while before they can freely spend again. However, the collective and comforting conclusion is that this financial adjustment process is making rapid progress as the Fed helps to ease debt burdens by slashing interest rates. According to Mr. Greenspan: *"The recent easings of reserve conditions would help to shore up the economy, and coming in the context of a solid trend toward lower inflation, have contributed to laying a foundation for a sustained expansion of the U.S. economy."*

By stressing that falling inflation and interest rates imply improving economic health, Mr. Greenspan echoed a widespread but ill-founded view. Almost every report we read expresses disappointment over economic trends but exults over the decline in inflation — the silver lining in the economic mire.

A non-inflationary environment is desirable for many reasons. Unfortunately, though, it is no cure for overindebtedness associated with a savage profit and income squeeze as is presently being experienced in all of the bubble economies. It's instructive to recall that the United States witnessed its greatest period of price stability ever in the 1920s. Yet, that boom sowed the seeds of the heaviest of all economic depressions. To again quote Keynes: *"Cheapness which means the ruin of the producer is one of the greatest economic disasters which can possibly occur."*

### **CAPITALISM WITHOUT PROFIT**

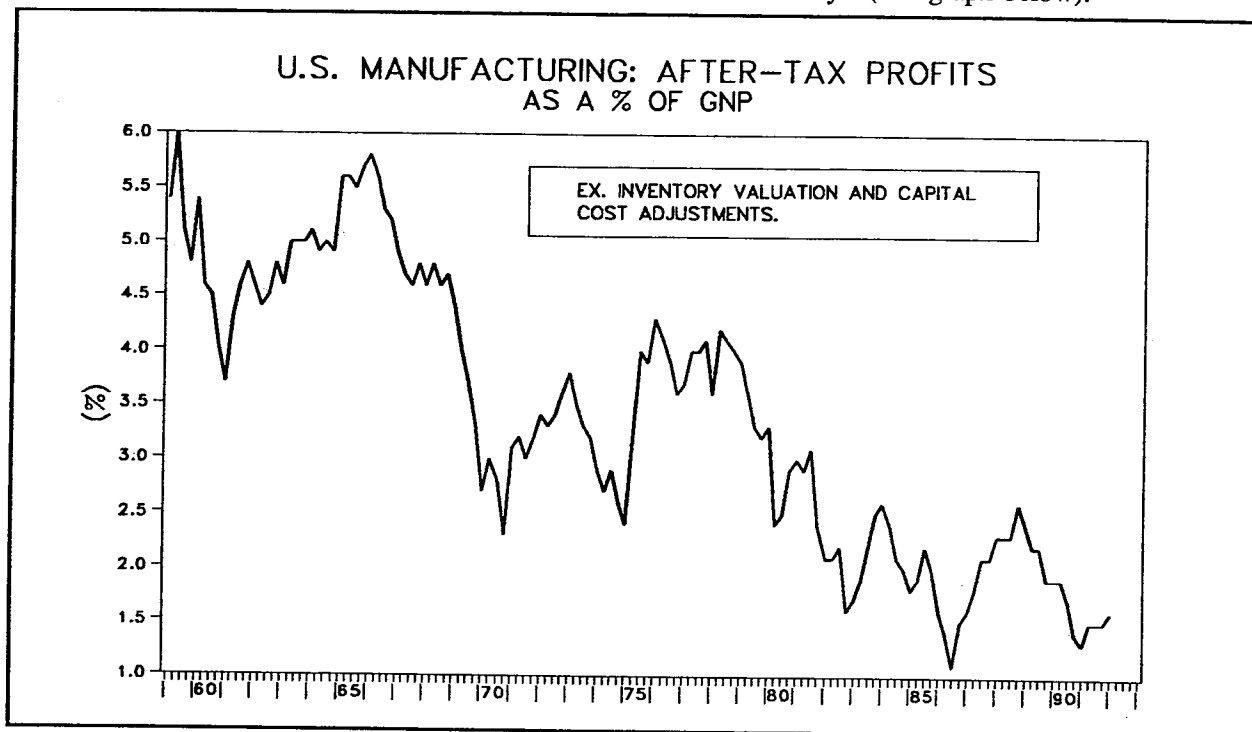
The reality in America, Canada, the U.K. and some other countries is a savage profit deflation that is translating into income deflation and income contraction. As is so often the case, Wall Street fails to see the critical part: namely, how the gains in price stability, labour productivity and profits are being achieved, and whether or not they are sustainable.

As we have stressed in the past, there are two different ways to improve labour productivity: by increasing capital per worker, as for example in Germany and Japan, or by shedding labour and unproductive plant without increasing net investment. In the United States, Britain and Canada, the productivity gains are overwhelmingly of the labour-shedding variety. It's a desperate, but futile, struggle to raise corporate profits out of a shrinking pie of income.

Speaking of profits, we come to the most important and most neglected subject concerning the economic situation of the Anglo countries: the fact that everything in our profit-seeking economies is regulated and determined by profits. Business profits are the mainspring of long-term growth as well as the mainspring of short-term economic fluctuations.

The U.S. economy is ailing from a variety of shortcomings and imbalances which converge on one focal point of crucial importance: a secular decline in business profitability. While profits rose in absolute amounts, they rose less than inflation and fell precipitously as a share of national income or GNP.

Worst of all, this profit disaster is centred in the manufacturing sector. Domestic manufacturing profits have tumbled from almost 6% of GNP in the 1960s to 1.5%-1.6% recently. (See graph below).



Our focus on domestic U.S. manufacturing profits has three reasons: firstly, their development is the most disastrous of all the sectors; secondly, manufacturing is the most productivity-enhancing part of every economy; and thirdly, it is the key sector for foreign trade. At the moment, it's particularly the latter point that attracts our curiosity because manufacturing, through the trade link, plays a key role in the supply and demand of a currency.

### **IS THE DOLLAR OVER- OR UNDER-VALUED?**

Looking at this disastrous performance of U.S. domestic manufacturing profits, many questions about causes and implications come to mind. However, we want to focus in on one aspect: the long-term consequences for the U.S. dollar. In short, we want to examine whether the dollar is over- or under-valued.

As was always the case, the overwhelming majority of international analysts and investors remains basically bullish on the U.S. dollar. Now that all of their bullish near-term arguments have meanwhile foundered, their last defense is the purchasing power parity (PPP) argument concluding that the dollar is unbelievably

cheap in terms of its domestic purchasing power. The dollar's PPP in D-mark is currently said to be somewhere between DM 1.80-2.00. Though no one explains how this exchange-rate adjustment will come about, the markets are full of PPP believers waiting for the dollar to power its way toward this mythical parity. It's the greatest and last chimera of the dollar bulls.

PPP is generally regarded as the best available measure of international competitiveness. However, if the PPP calculation is valid, U.S. manufacturing industry — benefitting most from currency undervaluation — ought to be super-competitive against its foreign competitors. U.S. manufacturing profits should be booming on the back of large export surplus.

Oddly enough, the facts are diametrically contrary. U.S. manufacturing, being exposed to foreign competition, has the lowest profits and investment levels in history. And, even though domestic demand is suppressed, the U.S. trade balance is still deep in the red.

An even greater nonsense is the new rage to relate PPP to asset prices and capital flows. A "cheap" dollar, as it is often argued, must mean "cheap" U.S. assets. On that basis, huge capital inflows will be attracted into the U.S., thus acting to boost the dollar. It's the other great, delirious hope of the dollar bulls.

Most obvious, in the first place, is that U.S. asset markets are presently among the most unattractive in the world either in terms of yield or price/earnings multiples. That's in striking contrast to the 1980s when foreign capital massively gravitated to the United States, driven by a host of favourable influences such as high U.S. interest rates, abolition of capital controls, the institutionalization of savings, global diversification of portfolios, increasing direct investment attracted by positive U.S. growth expectations, an invasion of foreign banks, and failing all that, the huge dollar purchases of the foreign central banks when private flows stalled. Foreign capital flooded in, readily financing a cumulative U.S. current-account deficit of about \$900 billion over the last ten years. Capital inflows into the United States accounted for about one-half of total inflows into industrial countries.

The evidence is that the PPP is nothing more than empty market hype. Two observations make that clear: For one, the U.S. trade deficit continues to run at an annual deficit of \$70-80 billion. The fact that this deficit persists even during a time of depressed domestic demand, bears strong witness that the deficit is attributable to structural factors and has little to do with currency levels.

Secondly, to maintain a stable dollar, a large, chronic trade deficit requires sustained, if not rising, capital inflows. That's virtually impossible if the U.S. economy stays mired in sub-par growth since that demands low, internationally unattractive interest rates.

Why is there such a large "structural" trade deficit? In short, it's due to a debilitated manufacturing sector. Essentially, foreign trade depends on the manufacturing sector. The obvious problem is the cumulative effect of under-investment in manufacturing and the resulting shortage of productive capital relative to total domestic demand.

The reason for the shortfall in investment is obvious: poor profitability. It's one of those vicious circles in which causes and effects reinforce each other. All of this clearly bears evidence that the PPP assessment of a grossly undervalued U.S. dollar is total nonsense. The dollar's secular bear market will remain in force as long as the outstanding weakness in savings, investment and profits continue.

## CONCLUSIONS

Worldwide, sentiment has shifted to a more sobering and realistic appraisal of economic events. All the Anglo bubble economies are more stagnant than recovering. Persistently high German interest rates and a waning of the unification-related demand boost means more economic weakness for Continental Europe. Only in Japan, due to exports, has a full-fledged recession been avoided.

All these economies face huge economic and financial adjustment problems that will tend to weaken them for years to come. Asset and debt deflation are only part of the problem. Supply-side constraints caused by years of underinvestment — particularly in manufacturing — hinder economic growth.

Stock markets around the world have begun to decline. We think there's more bearishness yet to come. Although the U.S. stock market is still believed to be healthy technically, in terms of valuation, it's at ridiculous highs. The next big move is bound to be a sustained decline, if not a crash.

Despite all of the past disappointments, there is still widespread hope reflected in the markets that the U.S. economy will be the first to recover. That expectation has been helping to underpin the U.S. stock market and the dollar. The real danger for the U.S. bond market is not inflation, but a soaring budget deficit and a potential "dollar crisis."

We see nothing that might cause the dollar to bottom out any time soon. A German monetary easing is not imminent, a U.S. economic rebound of any meaningful quality is not likely, and neither is any influx of foreign capital.

Growing concern over the future of European monetary union and the worry that the Bundesbank will keep its interest rates high for the rest of the year is straining Europe's currency system and has thrown its high-yielding capital markets into chaos. We don't see how some currency realignments can be avoided. The danger is that one single realignment will shake the whole system.

We can only repeat our long-standing recommendation: Safety first in D-mark and Swiss Franc hard currency bonds.



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